

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF FRIENDLY)	
UTILITIES, INC., D/B/A FRIENDLY)	
HILLS EAST SEWER SYSTEM FOR A)	CASE NO. 9129
RATE ADJUSTMENT PURSUANT TO THE)	
ALTERNATIVE RATE FILING PROCEDURE)	
FOR SMALL UTILITIES)	

O R D E R

On September 7, 1984, Friendly Utilities, Inc., d/b/a Friendly Hills East Sewer System, ("Friendly Utilities") filed an application with the Commission to increase its sewer rates pursuant to 807 KAR 5:076, the "Alternative Rate Procedure" for small utilities. On March 22, 1985, the Commission allowed Friendly Utilities rates calculated to increase its revenue by \$23,235 annually. By Order issued July 26, 1985, the Commission reopened the case because Friendly Utilities had failed to give proper notice to its customers as required by KRS 278.185, to allow the customers to participate.

On August 27, 1985, the Friendly Hills East Neighborhood Association ("Neighborhood Association"), by counsel, filed its Motion to intervene in the case and was granted full intervention status by the Commission's Order dated September 25, 1985.

Responding to customer requests for a public hearing, the Commission held a hearing on November 26, 1985, in the Commission's offices at Frankfort, Kentucky.

Due to several controversial issues discussed during the hearing, briefs were submitted by Friendly Utilities and the intervenor.

On January 10, 1986, Friendly Utilities filed a motion requesting authority to file testimony and supporting exhibits in rebuttal of intervenor's evidence on the issue of depreciation expenses. An objection to Friendly Utilities' motion was filed by Neighborhood Association on January 23, 1986. Since herein we reject the intervenor's position on depreciation expenses Friendly Utilities' motion is rendered moot.

DISCUSSION

During the hearing of November 26, 1985, the Neighborhood Association offered testimony of an accountant, Noble Rye. He asserted that the Public Service Commission erred in several areas with regard to its allowances and adjustments of certain operating expenses in the determination of Friendly Utilities' revenue requirements, and these contentions are considered herein.

Electric Expense

With regard to allowable electric expense for the test period, the Commission agrees that Friendly Utilities erroneously included invoices representing electric expense for a 13-month period. Invoices of \$1,028 were for a month prior to the test period and test period expense is reduced accordingly, for an adjusted electric expense of \$12,937,¹ a reduction of \$1,096.

¹ $\$14,033 - [\$1,028 + (\$1,028 \times 6.55\%)] = \$12,937.$

Chemical Expense

In the Commission's Order of March 22, 1985, chemical expense of \$833 was approved for rate-making purposes, based on a comparative analysis with the previous year's chemical cost of \$1,245. However, this included a purchase of chemicals prior to the test period (invoice number 5039083 dated May 1, 1982, from Ulrich Chemicals) in the amount of \$227. Furthermore, the Commission found that a drum deposit of \$100, which is refundable, was erroneously included, and cannot be considered as a rate-making expense. After these reductions, adjusted chemical expense for the test period is \$506.

Depreciation Expense

Friendly Utilities had recorded depreciation expense of \$11,140. In its Order, the Commission made an additional allowance of \$1,052 computed on the basis of a 3-year service life on depreciable property of \$3,157 which was transferred from the maintenance expense account. Neighborhood Association presented testimony and exhibits supporting depreciation expense of \$4,826 based on an allocation of investment as reflected in an earlier case and the purchase price of \$160,000 discounted for present value.

To determine the proper level of depreciation expense to be allowed for rate-making purposes, the Commission must review the history of the utility's plant in service and ascertain the proper value for computing depreciation.

Friendly Utilities acquired this utility plant in 1984 from Future Federal Savings and Loan Association. The Commission

approved this transaction by Order entered August 11, 1984, in Case No. 8459.² In approving said transfer, the Commission set forth in Finding No. 7 instructions regarding the proper accounting entries to be made by Friendly Utilities to record the purchase of the facility on its records. Those instructions included a requirement that there be a transfer of utility plant gross investments, accumulated depreciation reserve and other related plant accounts. A review of Friendly Utilities' subsequent Annual Reports and its financial statements filed herein reveal that its initial accounting entries were not in compliance with the instructions set forth in Case No. 8459. If it had followed those instructions, "utility plant in service" would have been shown as \$218,758, which was the original cost of plant in service found appropriate in Case No. 7087.³ The following credits would have been necessary to complete the transaction:

Reserve for Depreciation & Amortization	\$ 47,490
Contributions in Aid of Construction	11,268
Notes Payable	160,000

In Case No. 8459, the Commission also found that the "bargain purchase is in effect a contribution and should be passed on to utilities ratepayers."⁴ Thus, allowable depreciation expense for rate-making purposes would be calculated on \$160,000 for this

² Amended Application of Friendly Utilities, Inc., for Authority to Acquire and to Operate the Sewage Treatment Plant Owned by Future Federal Savings and Loan Association in Jefferson County, Kentucky and for Authority to Incur the Necessary Debt to Acquire the Said Sewage Treatment Plant.

³ An Adjustment of Rates of the Friendly Hills Sewage Treatment Plant, Order entered October 19, 1978.

⁴ Final Order in Case No. 8459, August 11, 1982, page 4.

system. The Commission rejects the Neighborhood Association's proposal to determine the value of depreciable plant on the present value of Friendly Utilities' outstanding notes. Following the instructions of the Uniform System of Accounts for Sewer Utilities, and based on these findings, allowable depreciation expense is as follows:

	<u>Net Investment at Acquisition</u>	<u>Remaining Life at Acquisition</u>	<u>Depreciation</u>
Land	\$ 14,400		\$ -0-
Treatment and Disposal			
Equipment	11,936	8.5 yrs.	1,404
Structures and Improvements	133,664	40 yrs.	3,342
	<u>\$160,000</u>		<u>\$4,746</u>
Depreciation expense on capitalized maintenance Exp.			1,052
1983 plant additions - \$4,732 ÷ 10 years =			473
Total			<u>\$6,271</u>

Taxes

Friendly Utilities projected federal and state corporate income taxes and the 2.2 percent Jefferson County occupational tax totalling \$2,622 as operating expenses. We allowed a combined tax expense of \$1,687 for rate-making purposes. Mr. Rye testified that the only tax which should be allowed in the pro forma rate structure is the 2.2 percent Jefferson County occupational tax, since as of December 31, 1983, Friendly Utilities had for tax purposes an accumulated carry forward net loss of \$38,052 which eliminates any payment of federal and state corporate income taxes for several years.

The Commission does not concur with this position. The inclusion of federal and state corporate taxes and the 2.2 percent Jefferson County tax in the adjusted operating expenses of

Friendly Utilities is justified in that the Commission is setting rates that will be applicable for the future and they should be self-sufficient irrespective of occurrences in previous years. Carry forwards brought about by past operating losses belong to the owners since the owners incurred the loss. The accounting witness also contended that Friendly Utilities earned an Investment Tax Credit which should have been amortized during the test period. No investment tax credit was claimed by Friendly Utilities upon purchase of the plant in 1982 and any such credits if claimed would have a minimal effect on annual taxes after amortization. Therefore, no adjustment has been made herein to reflect the amortization of a possible investment tax credit applicable to Friendly Utilities.

Collection Expense

Based on the reevaluation of Friendly Utilities' operating expenses, the Commission has made a downward adjustment of \$69 to collection expense which results in an adjusted annual collection expense of \$1,947.

SUMMARY

The Commission, after consideration of the evidence of record and being advised, is of the opinion and finds that:

1. Intervenor's computation of depreciation expense is contrary to the Commission's method, which is based on the Uniform System of Accounts for Sewer Utilities, and Mr. Rye's formula should be denied for rate-making purposes.

2. The Commission's Order of March 22, 1985, should be modified to reflect the following adjusted operations:

	Per 3-22-85 Order	Additional Adjustment	Adjusted
Operating Revenues	\$ 46,120	\$ -0-	\$ 46,120
Operating Expenses	49,875	<7,413>	42,462
Net Operating Income	\$ <3,755>	\$7,413	\$ 3,658
Interest Expense	10,761	-0-	10,761
Net Income (Loss)	\$<14,516>	\$7,413	\$ <7,103>

3. Based on the adjustments in Findings No. 1 and 2 and making the proper adjustments for the operating ratio of 88 percent, Louisville Water Company collection charges, Federal and Kentucky corporate income taxes and the Jefferson County, Kentucky, 2.2 percent occupational tax, the rates in the Commission's Order entered March 22, 1985, should be modified by the rates in Appendix A of this Order, which operates as a reduction of \$8,709⁵ in projected annual revenues.

IT IS THEREFORE ORDERED that:

1. The Commission's Order entered March 22, 1985, be and it hereby is modified in accordance with Findings No. 1 and 2 and affirmed in all other respects.

2. The rates in Appendix A be and they hereby are approved for service rendered by Friendly Utilities on and after the date of this Order.

3. Within 30 days of the date of this Order, Friendly Utilities shall file with the Commission its tariff sheets setting out the rates approved herein.

⁵ (\$42,462 + \$1,437 adjusted tax level) ÷ 88% + \$10,761 = \$60,646 - \$69,355 = \$(8,709).

4. Friendly Utilities' motion to file rebuttal testimony on depreciation expense be and it hereby is denied on the grounds that it is rendered moot by the rejection of intervenors' position.

Done at Frankfort, Kentucky, this 7th day of May, 1986.

PUBLIC SERVICE COMMISSION

Richard D. Hemmelf
Chairman

[Signature]
Vice Chairman

[Signature]
Commissioner

ATTEST:

Secretary

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE
COMMISSION IN CASE NO. 9129 DATED 5/7/86

The following rates and charges are prescribed for customers receiving sewer service from Friendly Hills E. Sewer System. All other rates and charges not specifically mentioned herein shall remain the same as those in effect under authority of this Commission prior to the effective date of this Order.

<u>Customer Class</u>	<u>Rate</u>
Residential	\$20.51
Multi Family	15.38
* Commercial & All Other	38.46 (Per Residential Equivalent)

* Residential Equivalent = 12,000 Gallons/Month based upon average monthly consumption.